Defending Liberty
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Section of Taxation

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July 19, 2004

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Re: Senate Finance Committee Staff Discussion Draft of June 21, 2004

Gentlemen:

I am writing on behalf of the Section of Taxation of the American Bar Association concerning the Senate Finance Committee Staff Discussion Draft released June 21, 2004. The views expressed in this letter represent the position of the Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

On June 21, 2004, the Senate Finance Committee released a staff discussion draft of various proposed reforms in the area of tax-exempt organizations (the "Discussion Draft"). The Section of Taxation of the American Bar Association organized a working group of experienced exempt organizations practitioners[1] to review the Discussion Draft and provide comments to the Senate Finance Committee and its staff in connection with the roundtable discussion scheduled for July 22, 2004. Our comments are linked to the specific numbered sections of the Discussion Draft. For the reader's convenience, we have attached several appendices, which treat particular issues in greater detail.

In general, our comments emphasize the value of added disclosure and the self-policing effect of disclosure requirements for exempt organizations.[1] Particularly for charities, but also for EOs generally, the increased public accountability resulting from the on-line availability of their annual returns on Forms 990 and 990-PF has caused many EOs to improve their governance and their financial management. Because on-line availability is a fairly recent development, we believe that significant further improvement will result over the next few years. We believe that appropriate disclosure is a cost-effective and proactive method of deterring potential abuse as well as providing regulators with increased ability to remedy past or current abuse.

A. Exempt Status Reforms

1. Five-Year Review. The Discussion Draft proposes that each EO would be required to submit information every five years, on the anniversary of the date on which the IRS first determined that the EO was in fact exempt, to enable the IRS to determine whether it continues to be organized and operated exclusively for exempt purposes and, thus, continues to qualify for exempt status. We believe that a periodic review of any organization to determine its continued qualification has certain merit. The question is whether a five-year mandatory review of every EO is either practical or possible, when viewed from the burden it would place on the over 1.6 million domestic EOs and the significant administrative burden on the IRS of collecting and evaluating this information in order to determine an EO's continuing tax exempt status. In the 1950s and 1960s, when there were far fewer charities in the U.S., the IRS required charities to file information after two years of operation for a final determination. Even with the far smaller number of organizations in play, the two-year review consumed significant resources; it reduced the number of agents available to audit known problem cases and created doubt in the mind of donors as to the deductibility of gifts.

We suggest that if interim review is desired, further study is needed to develop procedures that would avoid these unintended consequences. We also suggest that the IRS' limited resources could better be directed toward a more effective audit selection program tied to the electronic return filing system. Finally, we suggest that requiring EOs to make certain materials available for public inspection, as part of their annual returns or otherwise, would be a more efficient way of achieving greater transparency.

2. Donor-Advised Funds. The Discussion Draft includes numerous suggested changes to the administration of donor-advised funds ("DAFs"). A DAF is not a separate legal entity; rather, it is a bookkeeping entry on the books of a public charity, identifying assets as to which a donor may make non-binding precatory recommendations to the public charity for charitable distributions and for investment (the "donor advice" of the name). The assets of a DAF belong to the public charity which has control over those assets and discretion as to their investment and use.[1] The charitable purposes of a DAF and the rights and obligations of the public charity and the donor are generally set forth in a written agreement between the donor and the public charity. There is, however, no statutory or regulatory definition of a DAF,[2] and we believe that clarity here would help to prevent both intentional abuse and inadvertent error.

As we discuss in *Appendix A*, we support several of the Discussion Draft's proposals, e.g., requiring public charities with DAFs to refrain from making grants from DAFs to private non-operating foundations and requiring public charities with DAFs to obtain confirmation from the grantee that the grant will not convey a private benefit to the advising donor. However, we believe that several of the recommendations require further study in order to prevent abuse without also preventing important charitable activity where abuse is not present, or denying a significant economic benefit to the public charity to which the DAF assets belong. We welcome the proposed clarification that a public charity may pay a donor's non-binding charitable pledge from a DAF upon reviewing and approving advice from the donor/pledgor.

3. Supporting Organizations. The Discussion Draft recommends abolishing Type III supporting organizations. We agree that this vehicle has been abused in some instances, but we believe that abolishing it is not necessary. Instead, in *Appendix B*, we suggest reforms that we believe will prevent the abuses that prompted this recommendation while still allowing legitimate Type III supporting organizations to operate.

4. Credit Counseling Organizations. The Section of Taxation agrees that further attention to credit counseling organizations is appropriate. Because of the short time available to respond to the Discussion Draft, however, we offer no comments on the Discussion Draft's recommendations regarding the prevention of abuses in exempt credit counseling organizations.

5. Tax Shelter and Tax Avoidance Transactions. The Discussion Draft proposes that when the IRS determines that a charity is an accommodating party to a listed tax shelter transaction or a reported transaction with a significant tax avoidance purpose, the charity should be penalized by losing its ability to offer its donors a Section 170 charitable deduction for one year, and the charity should pay a 100% tax on accommodation fees or other direct benefits received. We agree, in concept, to penalizing charities that knowingly use their tax-exempt status to facilitate abusive tax shelters when it has been determined that a tax shelter is abusive, and, in *Appendix C*, we suggest issues that we believe should be considered in developing this proposal.

B. Insider and Disqualified Person Reforms

1. Self-Dealing and Disqualified Persons. The Discussion Draft proposes applying the private foundation self-dealing rules to public charities, with the exception of the compensation of insiders, which would be addressed by revising the existing Treasury Regulations to Section 4958. It also proposes to apply the definition of a disqualified person under Section 4946 (currently applicable to private foundations via Section 4941) to public charities while retaining Section 4958's inclusion of persons with substantial influence over the organization. Congress considered and rejected this approach in 1996 when it enacted Section 4958. As practitioners, we have seen positive changes in the behavior of public charities in this area since Section 4958 was enacted, particularly since the Regulations to Section 4958 were promulgated in 2002. Rather than extending the private foundation rules to public charities, in *Appendix D* we suggest an alternative: a series of targeted reforms that address abusive transactions but leave public charities the flexibility to engage in transactions with insiders where those transactions

are for the public charity's own benefit and do not confer an improper benefit upon the insider. We also recommend additional disclosure of transactions between public charities and their insiders.

2. Definition of Disqualified Person. The Discussion Draft would expand the definition of a disqualified person, as applied to public charities, to include a corporation or partnership with respect to which a disqualified person exercises substantial influence. As noted above, we believe that the existing provisions of Section 4958, including its definition of a disqualified person, should remain in place without modification. To address the concerns of the drafters, we suggest increased Form 990 disclosure of transactions involving public charities and corporations or partnerships in which a Section 4958 disqualified person has a substantial financial interest. Disclosure of all transactions between a charity and members of its board or partnerships or corporations in which a disqualified person has a material financial interest (similar to the proxy disclosure requirement that public companies disclose transactions with their board members) would provide the IRS, the general public and watchdog groups with sufficient information to monitor abusive situations.

3. Excise Taxes. The Discussion Draft proposes increasing the excise taxes currently imposed on acts of self-dealing (whether applied to private foundations or, as the drafters propose, to public charities) and on jeopardizing investments and taxable expenditures for private foundations. With regard to self-dealing, we suggest that if penalties are to be increased, abatement procedures should be put in place under Section 4962 for transactions that are due to reasonable cause rather than willful neglect. With regard to jeopardizing investments, we recommend updating and modifying the Section 4944 Regulations rather than increasing penalties for violating the current Regulations, which were drafted over 30 years ago and no longer provide useful guidance. The examples of types or methods of investment described in Treasury Regulation Section 53.4944-1(a)(2)(i), which will be closely scrutinized, do not reflect current investment practices and opportunities and do not recognize the current balanced-portfolio practices of foundations, including so-called alternative investments. Foundations today use sophisticated investment strategies to attempt to manage portfolios in accordance with modern portfolio theory, volatility considerations, and other matters. Rather than increase penalties in an area where a violation of the rules is unclear, the charitable community would be better served by updating and clarifying the rules. Finally, for both taxable expenditures and self-dealing, we believe that increased and rigorous enforcement of existing law by the IRS (funded, we hope, with excise tax revenues as the Discussion Draft recommends) is the most effective deterrent to abuse.

4. Private Foundation Trustee Compensation. Under the Discussion Draft, compensation of trustees[3] of private non-operating[4] foundations would either be banned or would be limited to a statutory maximum amount. In *Appendix E*, we describe several unintended consequences of this proposal which we believe would cause harm to the charitable sector. Instead of a statutory ban or cap, we suggest amplifying the guidance available to private foundations for determining whether trustee compensation is reasonable, possibly by reference to the rebuttable presumption procedures under the Regulations to Section 4958 (with appropriate modifications). Section 4941 already imposes penalties on the payment of unreasonable compensation to private foundation trustees; we question whether additional legislation is required.

5. Private Foundation Compensation of Non-Trustees. Under the Discussion Draft, compensation of disqualified persons to non-operating private foundations, other than those who are disqualified only by reason of employment, would be determined by reference to comparable federal government rates for similar work and one would not be able to look either to other charities or to the private sector for comparison. Compensation or severance payments to other persons above certain limits would trigger additional public disclosure and IRS review (for which a filing fee would be imposed) and all compensation subject to such filing requirements must be approved annually and in advance by disinterested members of the charity's governing body. As we suggest in *Appendix E*, we recommend an alternative: increasing Form 990-PF's compensation disclosure by increasing the number of employees and independent contractors whose compensation must be disclosed. If Section 4958's rebuttable presumption is extended to private foundations in some form, as we suggest above, it may be appropriate to require private foundations to affirm on Form 990-PF that they have followed the procedures required to obtain that presumption.

C. Grants and Expense Reforms

1. Private Foundation Administrative Expenses. The Discussion Draft proposes that private non-operating

foundations with administrative expenses (defined as any expense other than a charitable grant) above 10% of the foundation's total expenses would be required to file additional publicly available supporting materials with the IRS. The IRS would then review this material to determine whether the expense was reasonable and necessary and, thus, properly treated as a qualifying distribution of a private foundation. Administrative expenses over 35% of a foundation's total expenses would not count toward the foundation's minimum mandatory distribution. In light of the wide range of non-grant public benefit activities conducted by many private foundations (e.g., research, analysis, conferences, publications, technical assistance to other EOs for charitable purposes, and other directly operated programs that do not rise to the levels required for operating foundation status), we suggest instead dealing with administrative expenses along the lines adopted in H.R. 7 (as passed on September 17, 2003). H.R. 7 redefined what is allowed as an administrative expense and required the Secretary of the Treasury to write regulations on this definition. This H.R. 7 definition expressly recognized that administrative expenses directly attributable to direct charitable activities, grant monitoring and administration activities,[5] compliance with applicable federal, state or local law or furthering public accountability of the private foundation should continue to be considered qualifying distributions without regard to amount.

2. Incentives for Increased Grant Funding. The Discussion Draft proposes to waive the Section 4940 excise tax on the net investment income of any private foundation that pays out more than 12% of its non-charitable assets exclusively for grants. We are concerned that making this benefit available only in connection with increased grants, rather than including public benefit programs directly conducted by private non-operating foundations, would have the unintended and unfortunate consequence of curtailing these public benefit activities.

3. Private Foundation Grants to Donor-Advised Funds. The Discussion Draft would bar private foundations from making grants to donor-advised funds of public charities. We understand that this proposal may be prompted by concerns that some private foundations are "parking" assets in DAFs without recommending further distributions, and that some private foundations, in collusive transactions, are making distributions to DAFs and subsequently advising a grant back to themselves. We agree that such transactions should not be allowed. However, we believe that there are numerous situations where private foundation grants to donor-advised funds may enable the more productive use of charitable assets and bring greater, rather than lesser, independent oversight to the distribution of charitable funds. Therefore, we suggest a more narrowly focused approach to the abuses to which we believe the Discussion Draft's proposal is directed. Specifically, we note that distributions from one private foundation to another under Section 4942(g)(3) may not be counted toward the grantor private foundation's minimum distributions unless the grantee private foundation redistributes those funds before the end of the following tax year (in addition to satisfying its own payout requirement from other funds). A distribution from a private foundation to a donor-advised fund of a public charity could be treated similarly, though we suggest a redistribution deadline of up to five years in recognition of the discretion of the public charity that owns and controls the DAF assets. For this purpose, 'redistribution' means either a distribution to another charitable organization other than a private foundation, or a transfer of assets from a public charity's DAF to a fund of that public charity that is not subject to donor advice. If the private foundation is terminating its existence by distributing its assets to a DAF in a community foundation, however, we do not believe a mandatory redistribution deadline is necessary or appropriate.

4. Travel, Meals, and Lodging Expenses. Under the Discussion Draft, both private foundations and public charities would be able to pay travel, meals, and lodging expenses only up to the applicable U.S. government rates. Public charities (but not private foundations) would be able to exceed this limit only if, for each such expense, the charity's governing body approved the expense and the approval was reported on Form 990. While we support increased disclosure generally, we suggest that a simpler approach might be to follow the approach of H.R.7 here as well, which excluded private and chartered air travel and any commercial air travel that exceeded coach-class accommodation from the definition of qualifying distribution. We suggest, however, that an exception should be created for instances where private or chartered air travel is the only feasible way to reach communities being served, e.g. in Alaska and other rural areas where few or no alternatives exist.[6]

D. Federal-State Coordination of Actions and Proceedings

1. Standards for Acquiring or Converting a Nonprofit Organization. The Discussion Draft proposes establishing standards for review by state and federal authorities of conversion transactions from tax-exempt to for-

profit status, and creating a procedure for notifying the IRS of intent to convert. Current law provides significant safeguards in the event of conversion, including Section 4958's intermediate sanctions provisions, enacted in 1996, which impose substantial penalty excise taxes on disqualified persons who receive excess benefits from any transfers in which the exempt organization does not receive fair market value, and on organization managers who knowingly approve such transfers. We are concerned that the proposed process would add substantial cost and delay, and would often duplicate state proceedings, without significantly improving the current regulatory scheme. We are also concerned that a procedure which substitutes the IRS's judgment for that of the exempt organization's board as to the merits of a proposed transaction may not serve the best interests of the community. We suggest instead that the IRS might discourage abusive transactions, and more reliably identify those that do occur, by requiring prior notice by means of a simple form which (a) defined a conversion transaction; and (b) required the tax-exempt organization to document both the fair-market-value consideration for its assets and compliance with rebuttable presumption procedures under the intermediate sanction rules for any disqualified persons involved.

2. State Authority to Pursue Federal Actions. The Discussion Draft proposes giving states the authority to pursue certain federal tax violations by exempt organizations with the approval of the IRS, and notes that the states already have such authority with respect to certain federal law violations that are enforced by the Federal Trade Commission ("FTC"). With respect to consumer protection investigations and suits, most states have enacted so-called "Baby FTC Acts" that parallel the federal law. The states have the authority to enforce those state laws – not the federal law. The states are authorized to commence civil suits and bring actions under the federal anti-trust laws, either for injuries suffered by the state itself or in a *parens patriae* role on behalf of their citizens. With respect to the federal law of tax exemption, state laws already encompass concepts of charitable trust and fiduciary duty on which the federal law is based. Many states in addition have standards for state tax exemption that are similar to the federal tax law. We question whether there is any additional enforcement benefit to be gained from providing authority to the states under the federal tax laws.

E. Improve Quality and Scope of Forms 990 and Financial Statements

1. Signature on Form 990/990-PF. The Discussion Draft recommends requiring the EO's chief executive officer to sign the EO's annual returns. We suggest that since many smaller public charities are run by volunteers, who do not work for the charity on a daily basis, a more effective alternative may be to require the signature of an officer or key employee in a position to certify that the return is complete and accurate. Form 990 might also include a check-box affirmation that copies of Form 990 were provided to each member of the EO's governing body. In general, however, we agree with this recommendation.

2. Penalties for Failure to File. The Discussion Draft would increase the penalties for failure to file a complete and accurate Form 990. With regard to failure to file, we suggest that a more effective deterrent would be to leave the current penalty structure in place but limit the number of times that penalties could be abated. This would not discourage delinquent filers from "coming in from the cold" but would preclude willful violators from taking improper advantage.

3. Extensions of Time to File Form 990. Under the Discussion Draft, extensions of greater than four months would be considered a failure to file, leading to significant penalties. In our experience, charities do not delay filing their 990's by choice. Larger charities with investments in partnerships, for example, cannot accurately report the value of their investments until the partnership provides Form K-1 to the charity. Smaller charities often find that they cannot secure the services of a CPA to prepare Form 990 during the January-May "busy season" at an affordable rate. We agree that timely reporting is to be encouraged, and we urge the development of other incentives.

4. Electronic Filing. The Discussion Draft would impose deadlines on the IRS e-filing capability for 990 filers and require the IRS to coordinate e-filing with state officials. We agree that e-filing should be encouraged, and we note that the IRS is actively working toward this goal. We also note, however, that with each addition to Form 990 (such as those recommended in the Discussion Draft and in these comments), implementing the e-filing function becomes a more complex task. Since the IRS is currently devoting significant resources to a complete revision of Form 990 and its variations, we are concerned that the goals of full disclosure of relevant information, coordination and information-sharing with state charity officials, and electronic filing may work inadvertently at cross-purposes. We suggest that the deadline be presented as a goal, rather than a requirement.

5. Form 990 Standards. The Discussion Draft would require the IRS to promulgate standards for filing Form 990 by a specified date in order to promote consistency among similarly situated EOs. Standards for financial statements, under the Discussion Draft, would conform to the Form 990 standards. We note that several efforts are already underway in the voluntary sector to promote consistent reporting on Form 990 and its variations.[7] We suggest that the EO Compliance Unit that the IRS established earlier this year and the EO Data Analysis Unit that is expected to be in place later this year should be given the opportunity to determine where additional training and guidance may best be focused.

6. Audits and Reviews. The Discussion Draft would require EOs to attach a written review of an independent auditor "for conformity to established Form 990 filing standards." EOs with more than $250,000 in gross receipts must attach an independent financial statement audit, including certification regarding the EO's exposure to the unrelated business income tax; EOs with receipts between $150,000 and $250,000 must attach a CPA's review rather than an audit. A new auditor would be needed every five years. We note that in many areas of the country, there are few auditors with EO expertise and it may be impossible to secure their services at reasonable cost, let alone secure a replacement every five years. We also note that until standards for Form 990 are promulgated as suggested in the preceding paragraph, it may be difficult for an auditor to provide the proposed certification. Various states have adopted different audit thresholds (and many states have none); if audits are to be required, we suggest that the national threshold should focus on EOs with larger asset bases.

7. Other Disclosure Recommendations. Under the Discussion Draft, EOs would have to attach an affiliations chart to Form 990 that discloses the EO's relationships with each affiliated organization, whether or not exempt. Form 990 would require enhanced disclosure regarding taxable subsidiaries and their relationship with the EO, transactions with insiders, ancillary joint ventures, and all partnership interests including the EO's role in the partnership. The EO would also have to attach copies of all tax opinions that it received involving agreements with insiders and all conflict of interest opinions. We note that large public charities, such as hospitals and universities, are part of affiliated groups in which many participants already file returns independently; this disclosure requirement would thus be a duplication of effort and a burden on government as well as on the EO sector. These considerations also apply to taxable subsidiaries. With regard to partnership interests, in most cases the charity is a passive investor; where the charity plays an active role, however, we agree that disclosure is appropriate. Finally, we are concerned that requiring disclosure of all tax opinions and conflict of interest opinions – entirely aside from questions of privilege – will have the harmful and unintended consequence of discouraging EOs from seeking legal and tax counsel on complex transactions. Without such advice, smaller charities in particular are likely to fall victim more frequently to promoters who do not have the charities' best interests in mind.

8. Performance Goals and Governance Disclosures. The Discussion Draft would require charities with over $250,000 in gross receipts to include in Form 990 a detailed description of their performance goals and how they propose to measure their progress toward those goals, as well as material changes in their activities, operations, or structure. EOs would have to report how often the Board met during the year, and also how often the Board met without the CEO (or equivalent) present. Taking these points in the order presented, we note that many legitimate charities have goals that do not lend themselves to quantification or easy measurement. We also note that Form 990 currently asks for much information on an EO's activities in Part III, Statement of Program Service Accomplishments. Information on the frequency of Board meetings could be included in the governance disclosures that we suggest in our comments on Part G.

9. Public Charity Investment Disclosure. The Discussion Draft proposes to require public charities to make available, on request, information on their investments similar to (though apparently not as detailed as) what is currently required of private foundations. We note that Form 990 already requires investment disclosures, including aggregate capital gain and loss and a schedule of itemized sales of non-publicly traded securities and lump sum sales of publicly traded securities. These disclosures already provide a measure of accountability to the public regarding a public charity's stewardship of its funds. We suggest that detailed disclosure is appropriate for private foundations because they rely either on gifts from living donors who control their operations or on the income from their endowments; unlike public charities, private foundations typically have no stakeholders to hold them accountable. An alternative approach may be to require public charities to provide additional disclosure for any investment of the charity in which a Section 4958 disqualified person has a material financial interest.

F. Public Availability of Documents

1. Financial Statement Disclosure. The Discussion Draft would require EOs to disclose their financial statements to the public. We suggest considering this proposal in the context of revisions to Form 990 and 990-PF.

2. Web Site Disclosure. Under the Discussion Draft, EOs with web sites would have to post any returns that present law requires to be made public, along with their tax exemption application, their determination letter, and their financial statements for the most recent five years. Aside from questions of whether financial statement disclosure remains important in light of the extensive revisions proposed here to Form 990, and whether financial statements should be public for a longer period than tax returns under Section 6104, we note that there are practical problems for small organizations that would need to hire outside consultants to maintain and post the required documents to their web sites. We note also that posting Form 990 is duplicative, as Forms 990 are already available to the public at www.guidestar.org.

3. Audit and Closing Agreement Disclosure. The Discussion Draft would require the results of EO audits and closing agreements to be disclosed without redaction unless the audit or closing agreement resulted from the EO's voluntary disclosure. In that case, the EO's identity may be redacted. We agree that voluntary compliance must be encouraged. We are concerned, however, that this proposal may achieve the opposite effect: it may encourage charities to avoid closing agreements and proceed to litigation. Although litigation documents are often matters of public record, it is much more difficult to gain access to them. The prompt release of redacted EO audits and closing agreements, like the release of redacted private letter rulings and Technical Advice Memoranda, promotes public understanding of IRS interpretations and applications of the tax law and would contribute to compliance in itself.

4. Form 990-T Disclosure. The Discussion Draft also proposes to require Form 990-T, on which an EO reports its unrelated business income, to be made public with appropriate redactions, e.g. for trade secrets. The returns filed by affiliated organizations may also be made public, possibly as part of a revised Form 990-T. It is not clear to us what purpose this disclosure is intended to serve or what abuses it is intended to remedy. We note that the Congressional policy behind the unrelated business income tax was to permit EOs to engage in unrelated businesses but to tax them at rates comparable to taxable enterprises so that they did not have an unfair advantage. Consistent with this notion of parity of treatment between EOs and for-profit businesses, we believe that EOs should not be treated more harshly. Since the tax returns of for-profit businesses are not publicly available, the unrelated business income tax returns (as opposed to the annual returns on Forms 990/990-PF/EZ) should not be publicly available either. To do otherwise would, we believe, undercut the "level playing field" goal of Congress in enacting this tax regime for EOs.

5. Disclosure of Donations by Publicly Traded Corporations. The Discussion Draft recommends requiring publicly-traded corporations to file annually each year, with the IRS, a return showing all gifts over $10,000 (in the aggregate) for which the corporation claims a charitable deduction in that year; this return would be publicly available. We note that Congress considered and rejected this requirement in connection with the Sarbanes-Oxley Act.

G. Encourage Strong Governance and Best Practices for Exempt Organizations

1. Federal Standard of Care and Liability for Breach. The Discussion Draft proposes to create a federal standard of care for members of a charity's governing body[8] and to establish federal liability for breach of a director or trustee's duty to the charity. It would also require special attention to, and enhanced disclosure of, management compensation arrangements. Because the laws of the fifty states differ in important respects regarding the governance of charities, any transition to a federal standard should be developed with great care and in close coordination with state attorneys general. We suggest, in the interim, that adding questions to Forms 990/EZ/PF on governance practices would encourage better governance while also providing the IRS and the public with information on actual governance practices of the charitable sector as a whole. We also suggest that some of the proposals could lead to unintended and harmful consequences. In *Appendix F*, we suggest alternative methods for addressing the concerns that prompted the Discussion Draft's recommendations.

2. Board Composition. The Discussion Draft proposes several rules regarding the composition of a charity's governing body. In *Appendix F*, we suggest that enhanced disclosure on Form 990 would encourage charities to pay close attention to governance issues without imposing a "one size fits all" structure and would also enhance the ability of government regulators to oversee charitable operations. It would also avoid unintended consequences that would make it more difficult for charities to operate productively.

3. Eligibility for Board Service. The Discussion Draft recommends barring any person who has been convicted of certain crimes or who is barred from service on the board of a publicly traded corporation from serving as an officer, director, or trustee of a charity, in some instances for a specified period of time and in other cases permanently. The Discussion Draft also recommends authorizing the IRS to require the removal of any director, officer, or employee of an EO who has been found to violate certain rules and to ban such a person from serving on any other EO's board for a period of years. We believe existing law contains sufficient penalties and remedies for one-time violations. However, in the rare case where such violations are repeated and willful, we believe it is appropriate to grant the IRS the authority to require the removal of an officer or director, subject to appropriate judicial review.

4. Preference for Accredited Charities. The Discussion Draft suggests giving preference in government contracts and grants to organizations that have been accredited, as discussed below, and to conditioning participation in the Combined Federal Campaign on a charity's adoption of certain specified and nationally consistent best practices, including accreditation. For the reasons stated in the next section and discussed further in *Appendix F*, we believe that this recommendation should be reconsidered.

5. Charity Accreditation. The Discussion Draft recommends (and proposes funding for) a nationwide charity accreditation program to be developed by the IRS in conjunction with EOs that would create and manage such programs for states and/or for particular categories of charities. The IRS would have the authority to condition charitable status, and the ability to offer donors a charitable deduction, on whether a charity is accredited. We believe that responsible self-regulation is a trend that government should encourage. However, we are concerned that having the IRS or any other government agency use the standards of best practices set by charitable organizations as standards for granting exempt status or allowing federal income tax deductions for donations could work at cross purposes to development of the highest standard of corporate governance, as self-regulatory groups might be discouraged from setting high standards if government benefits and penalties were tied to those standards. Moreover, governmental reliance on standards set by private organizations may constitute the delegation of governmental rulemaking authority to the private sector, an action that should be undertaken only with the greatest of care.

6. Prudent Investor Rule. The Discussion Draft proposes applying a prudent investor rule to the investments of charities. As the Discussion Draft notes, many states have adopted prudent investor standards for nonprofit organizations; indeed, the Draft proposes that any new federal standard would be informed by such state standards. In addition to specific state standards, directors and trustees of charitable organizations are subject to common law fiduciary duties that apply to their oversight of investments. Further, the majority of states have adopted the Uniform Management of Institutional Funds Act (1972) (UMIFA). UMIFA applies an "ordinary business care and prudence" standard to the investment of endowment assets of corporations and unincorporated associations that are organized and operated for charitable purposes. The American Law Institute's Restatement (Third) of Trusts (1992) and the Uniform Prudent Investor Act adopt a prudent investor standard of care for investments. Given the existence of such common law and state standards, we suggest that it is unclear what goals would be served by the addition of a federal standard in the context of public charities. We suggest that this issue requires further study before legislation is considered.

H. Funding of Exempt Organizations and for State Enforcement and Education

The Section of Taxation and its Exempt Organizations Committee have long advocated for improved funding for federal and state oversight of EOs generally and charities in particular, including educational efforts.[9] We endorse the Discussion Draft's proposal to reinstate the appropriation of Section 4940 tax revenues to this governmental function. We also endorse the development of information-sharing protocols that would allow charity regulators on the state and federal levels to communicate with each other, with appropriate safeguards in place.

I. Tax Court Equity Authorities, Private Relator and Valuation[10]

1. Tax Court Equity Power. The Discussion Draft proposes investing the U.S. Tax Court with certain equity powers, including the power to rescind transactions, surcharge trustees and order accountings, in order to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and power to substitute trustees, divest assets, enjoin activities and appoint receivers to ensure that an organization's assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future. Here as in Part G, we are concerned that this proposal creates a federal standard of fiduciary duty that will create more, rather than less, uncertainty and confusion. We are also concerned that Tax Court judges, who are selected for their technical tax expertise and who are generally not called to employ equity principles, would be granted greater equity powers than those afforded to most state court judges in similar instances.

2. Director/Trustee Standing. The Discussion Draft proposes to grant standing to bring a proceeding in the right of a charity to any person who is a director or trustee of that charity. It is not clear from the Discussion Draft whether the proposal contemplates standing in federal court, state court, or both. We suggest that such standing on a state level, which exists under the laws of most states and the Revised Model Nonprofit Corporation Act, is to be encouraged, but for the reasons explained in our comments, we do not support the creation of a federal private right of action to enforce the tax law.

3. Standing for Other Individuals. The Discussion Draft proposes to permit any individual to submit a complaint about a charity to the IRS for review; if both the IRS and the appropriate state authority decline to pursue the matter, the individual would have the right to bring suit against the charity. We suggest that granting open-ended relator status, without requiring any connection between the complainant and the charity, could have serious unintended consequences similar to those that led Congress to reform the federal securities laws in the Private Securities Litigation Reform Act. We recommend against adopting this proposal.

4. Valuation. The Discussion Draft recommends adoption of a procedure known as "baseball arbitration" to resolve differences between donors and the IRS regarding the value of property donated to a charity. We are concerned about the effect on tax law generally of endorsing a specific approach to determining the value of property in a particular area, since the concept of valuation is key to many areas of tax law unrelated to charitable giving. Setting this issue aside for the moment, we suggest considering the variation known as "night baseball arbitration" in order to counteract the possibility of administrative bias in the IRS appeals process. We suggest, however, that at the litigation stage the determination of value is a question of fact that is best left to the judge or jury as the trier of fact, and that a procedure that affects the taxpayer's right to a jury trial in U.S. district court may raise constitutional issues.

Conclusion

We appreciate the opportunity to provide comments to the Senate Finance Committee and the Committee staff. Should you wish additional information on any of the matters discussed in this paper, please contact Stuart Lewis, the Section's Vice-Chair for Government Relations, at (202) 452-7933.

Sincerely,

Richard A. Shaw
Chair, Section of Taxation

cc: Gregory Jenner, Acting Assistant Secretary of the Treasury (Tax Policy)
George Yin, Chief of Staff, Joint Committee on Taxation
Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
Russ Sullivan, Democratic Staff Director, Senate Finance Committee
Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee

[1] Principal responsibility was exercised by Betsy Buchalter Adler and LaVerne Woods. Substantive contributions were made by Carolyn M. Osteen, Douglas M. Mancino, Eve Borenstein, Paul Feinberg, Lisa Johnsen, James P. Joseph, and Christopher Jedrey with comments from other members of the Section of Taxation's Exempt Organizations Committee.

[2] Some of the proposals apply to all exempt organizations while some apply only to those that are exempt under Internal Revenue Code Section 501(c)(3). In this paper, "EO" refers to all organizations that are exempt under Section 501 and "charity" refers to organizations that are exempt under Section 501(c)(3).

[3] Some public charities, such as community foundations, make grants from unrestricted funds as well as from DAFs. Others, such as universities and religious institutions, conduct direct charitable, educational, or religious activities and operate DAFs as a secondary or tertiary activity. For still others, such as the various national-scope grantmakers founded by various financial institutions, DAF grantmaking is their primary activity. Finally, a small but significant group of public charities, in some cases linked with domestic public charities (or foreign public charity equivalents) that operate their own programs abroad, makes DAF grants with international scope.

[4] The IRS has looked to Section 1.170A-9(e)(11) of the Treasury Regulations, which sets forth standards for when a component fund of a community foundation may be treated as a part of that community foundation, for guidance in the DAF area. One essential element of those Regulations is the absence of any material condition or restriction on the community foundation's use of the assets. These Regulations, however, were promulgated before the recent significant growth in assets held by public charities in DAFs and before investment firms created national-scope charities whose primary activity was the management and operation of DAFs.

[5] Whether the authors intended this provision to apply to only to trustees of private foundations organized as trusts or also to members of the governing body of private foundations organized as corporations (who may be referred to as trustees, directors, or Board members), the basic principle of reasonable compensation is the same. However, unlike trustee fees, the laws of most states do not address the stipends of board members of nonprofit corporations.

[6] A private operating foundation under Section 4942(j)(3) spends at least 85% of its annual net income on the direct and active conduct of its own charitable programs; its donors are treated as having donated to public charities for purposes of Section 170. Other private foundations are sometimes termed "non-operating foundations."

[7] We note that the Department of the Treasury has worked to alert charities and other EOs to the need for enhanced anti-diversion efforts in light of reported abuses resulting in the diversion of charitable assets to the support of violence or terror. These efforts are essential; they are also time-consuming and costly. We believe that it is important to avoid creating counter-incentives to implementing and maintaining these good practices.

[8] See, e.g., *Chronicle of Philanthropy*, March 4, 2004, interview with Diane Kaplan of the Rasmuson Foundation at p.17.

[9] For a recent example *see, e.g.*, Letter of April 23, 2004, from Richard A. Shaw, Chair, American Bar Association Section of Taxation, to the Senate Appropriations Subcommittee on Transportation/Treasury and General Government, stating that it is essential that the IRS have adequate funding to ensure its ability to carry out its mission in the administration and enforcement of the tax laws of the United States, available at www.abanet.org/tax/pubpolicy/2004/040423sen.pdf.

[10] For example, in Minnesota representatives of the Attorney General's office, the private EO bar, the CPA community, and finance officers of Minnesota charities began working together in 2001 as the Minnesota Nonprofit Accountability Collaborative (NAC) to design workshops and publications on the theme "Making Your Form 990 Work for You." That effort, which culminated in 2003, yielded eight workshop presentations to date and produced two technical assistance publications for lay readers, including "Tips for Telling the Truth – a Form 990 Tool," available at www.crcmn.org/npresources/truthtips.pdf. This publication addresses the four areas where the NAC found that 990 preparers needed the most education: explicating program service accomplishments; documenting and disclosing expenses appropriately under the Statement of Functional Expenses; understanding what comprises reportable fundraising expenses; and disclosing insider transactions and compensation.

[11] The Discussion Draft speaks in terms of board members but makes clear that these duties, and other recommendations in this section of the Discussion Draft, would also apply to trustees of charitable trusts.

[12] Further information on each element of Part I is provided in *Appendix G*.